DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0384
ADJUSTED GROSS INCOME, GROSS INCOME, and FINANCIAL INSTITUTIONS TAXES
For the Years 1996 through 2000

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ISSUES

I. Taxpayer's Qualifications to File Under Indiana's Financial Institutions Tax.

Authority: IC 6-5.5 et seq.; IC 6-5.5-1-17(d)(1); IC 6-5.5-1-17(d)(2)(A), (B); IC 6-5.5-1-17(d)(2)(B); IC 6-5.5-3-1; 45 IAC 17-2-1(a); 45 IAC 17-2-4(b), (c); 45 IAC 17-2-4(b)(1)-(3); 45 IAC 17-2-4(e)(2).

Taxpayer argues that it is qualified to file under Indiana's Financial Institutions Tax and that further review of taxpayer's previous arguments will support that conclusion.

II. Lease Payments Subject to Gross Income Tax.

Authority: IC 6-2.1-2-2(a); IC 6-2.1-2-2(a)(2); Comdisco, Inc. v. Indiana Dept. of Revenue, No. 49T10-9903-TA-19, 2002 Ind. Tax LEXIS 93 (Ind. Tax Dec. 18, 2002); Enterprise Leasing v. Indiana Dept. of Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002); First National Leasing 598 N.E.2d 640 (Ind. Tax. Ct. 1992); 45 IAC 1.1-1-3(a), (b).

Taxpayer maintains that if it is not qualified to file under the state's Financial Institutions Tax, money received from sales/lease agreements with Indiana customers is not subject to the state's gross income tax.

III. Including the Value of Leased Equipment in Taxpayer's Property Factor – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(b); IC 6-3-2-2(c).

Taxpayer argues that the value of equipment leased to its Indiana customers and clients should not have been included in its property factor for purposes of calculating taxpayer's adjusted gross and supplemental net income taxes.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation headquartered in Illinois. Taxpayer is in the business of leasing and financing the purchase of construction equipment and engines. The equipment and

engines are manufactured by a related company and are made available through a related network of local dealerships. Taxpayer earns money by entering into various forms of transactions with taxpayer's local dealerships, municipalities, and with individual customers. The "lease" transactions hereinafter described are – to a substantial degree – "sales/lease" agreements which provide a means by which the lessee acquires ownership of the leased equipment but which permit taxpayer to retain a security interest in the equipment during the term of the lease itself.

DISCUSSION

I. Taxpayer's Qualifications to File Under Indiana's Financial Institutions Tax.

Taxpayer submitted Financial Institutions Tax (FIT) returns for 1996 through 1997 on the ground that it was properly classified as a "Financial Institution" and that it was entitled to pay Indiana tax on that basis.

The Department of Revenue (Department) conducted an audit of those returns after which it concluded that taxpayer was not qualified to file as a Financial Institution. Under the Department's analysis, taxpayer did not meet the 80 percent threshold set out in IC 6-5.5-1-17(d)(2)(B). Therefore, the Department found that taxpayer should pay Indiana tax under the state's gross income, adjusted gross income, and supplemental net income scheme.

Taxpayer submitted a protest to the Department's decision, an administrative hearing was conducted, and a Letter of Findings (LOF) was issued in which it was concluded that "a cursory review of the taxpayer's 1996 and 1997 federal tax returns indicate that taxpayer is ineligible to qualify to file under the Indiana FIT."

In a request for a rehearing on the matter, taxpayer asked the Department to reconsider its decision; taxpayer was granted the opportunity for a second administrative hearing. The Department reexamined taxpayer's sales/lease transactions, reconsidered the taxpayer's arguments, and reviewed taxpayer's business transactions in light of the FIT statutes and regulations. A Supplemental Letter of Findings (SLOF) was issued which concluded that, "No matter upon which basis [taxpayer's] numbers are calculated, the percentages fall short of the 80% FIT benchmark. Taxpayer is not qualified to file under the state's Financial Institutions Tax."

Taxpayer was dissatisfied with the conclusions contained in the SLOF. Taxpayer requested and was granted a second rehearing. That second rehearing was held, taxpayer's business transactions and lease arrangements were again reviewed, and a second SLOF was issued. The second SLOF concluded that "taxpayer fails to meet the 80 percent benchmark necessary to file under the state's Financial Institution's tax."

Subsequent to the issuance of the second SLOF, taxpayer sought a clarification of the means by which it was required to calculate its gross income for purposes of qualifying to file under the FIT. The Department responded by issuing a Revenue Ruling (RR) in January of 2003. The RR stated that taxpayer was "required to include the gross income derived from finance lease/conditional sales in calculating the 80% test to determine the requirement to file and pay under the Indiana Financial Institutions Tax."

Taxpayer requested further clarification of the RR. After receiving that clarification dated May 26, 2003, taxpayer submitted requests for refunds based upon it 1996 and 1997 tax payments. Those requests were denied. In October 29, 2003, the Department issued a second clarification letter in which it essentially repudiated the first clarification letter.

Taxpayer now asks the Department to revisit the FIT issue, to arrive at a conclusion that taxpayer is entitled to report its Indiana income under the state's FIT, and to arrange for a refund of taxes paid as a result of the Department's purportedly mistaken decisions.

Indiana imposes a franchise tax, known as the Financial Institution Tax (FIT), on corporations transacting the business of a financial institution inside the state. IC 6-5.5 et. seq. The FIT is imposed on resident financial institutions, nonresident financial institutions, and on certain non-bank entities that transact the business of a financial institution. 45 IAC 17-2-1(a). Non-resident corporations, such as the taxpayer, transacting the business of a financial institution, are included in the FIT, after they first meet one of the eight tests set out in IC 6-5.5-3-1 whereby the non-resident corporation demonstrates that it has established an economic presence in Indiana. It is not disputed that taxpayer has established an economic presence in Indiana. That particular issue will not be revisited.

Because the taxpayer is not conducting the business of a traditionally regulated financial institution as defined in IC 6-5.5-1-17(d)(1), the taxpayer predicates its claim to FIT status under the provisions of IC 6-5.5-1-17(d)(2)(A), (B) which grant FIT status to those corporations which receive 80 percent of their gross income from the "[m]aking, acquiring, selling, or servicing loans or extensions of credit" or from the "leasing [of] real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes"

The benchmark for determining whether a taxpayer is "conducting the business of a financial institution" is if 80 percent of the corporation's gross income is derived from the economic equivalent of extending credit. 45 IAC 17-2-4(b), (c). The taxpayer may reach this 80 percent benchmark in one of three ways. It may do so by deriving 80 percent of its income from "(1) Extending credit . . . (2) Leasing that is the economic equivalent of extending credit [or] (3) Credit card operations." 45 IAC 17-2-4(b)(1)-(3).

An explanation of "the economic equivalent of the extension of credit" is found within the Department's regulations. 45 IAC 17-2-4(b), (c). The corporation must not only derive 80 percent of its income from collecting interest, that interest must be derived from a lease that is "*not* treated as a lease for federal income tax purposes." 45 IAC 17-2-4(e)(2) (Emphasis added). Therefore, to satisfy the requisite 80 percent benchmark, the interest must be both "the economic equivalent of the extension of credit" and from a lease "*not* treated as a lease for federal income tax purposes."

The Department has previously considered taxpayer's qualifications to file under the state's Financial Institution's Tax and has concluded that it is not entitled to do so. The Department has considered and reconsidered taxpayer's various lease transactions and determined that some of the lease agreements are "qualifying transactions" – the proceeds of which can be accumulated to reach the 80 percent threshold – while some of the leases are not qualifying transactions – the proceeds may not be accumulated to reach that threshold.

Taxpayer's lease agreements and business practices have been closely reviewed. The Department has carefully considered taxpayer's arguments on repeated occasions. The Department has issued a number of documents explaining the state's FIT and whether taxpayer is qualified to file under that tax regime. Despite taxpayer's obvious persistence, the Department is not prepared to expend further resources in revisiting these same issues in yet another detailed reanalysis of these same Indiana transactions. Neither the facts nor the law warrant yet further consideration of taxpayer's argument that it is entitled to report its Indiana income under the FIT; taxpayer is not.

FINDING

Taxpayer's protest is denied.

II. Lease Payments Subject to Gross Income Tax.

Taxpayer maintains that it is not subject to gross income tax on the money it received as sales/lease payments from Indiana customers. Taxpayer's argument is that it has a de minimis amount of property located within the state, that the sales/lease agreements were negotiated and accepted by taxpayer at a location outside of Indiana, and that the sales/lease payments were received at locations all of which were outside the state. In effect, taxpayer concludes that these receipts were not Indiana source income for gross income tax purposes.

Taxpayer describes its sales/lease business as follows. A potential Indiana customer will contact one of taxpayer's local Indiana dealerships. If the customer decides to finance or lease the equipment, the dealer will forward the customer's application to taxpayer's regional office in Chicago. Taxpayer will review the customer's information, determine the customer's credit-worthiness, and decide on the terms of the sales/lease agreement. That draft agreement is returned to the dealership. If the customer decides to accept the proposed agreement, customer signs the agreement, and it is returned to the Chicago office. The agreement is again reviewed to assure that everything is in order; if the taxpayer gives final approval, the financing is completed, and the customer arranges to accept delivery of the equipment.

Taxpayer summarizes, "All Lease Agreements entered into by [taxpayer] were created, negotiated, and accepted by [taxpayer] outside of Indiana." Under those conditions, taxpayer concludes that the sales/lease payments were not Indiana source income for gross income tax purposes. The issue is whether Indiana can tax the gross income earned as a result of sales/lease agreements with Indiana customers.
IC 6-2.1-2-2(a) imposes a gross income tax on the receipt of "the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana." IC 6-2.1-2-2(a)(2).

There is no disagreement that the sales/lease payments are "gross income." However, in order for the payments to be subjected to Indiana gross income tax, the payments must have been derived from "sources within Indiana." Id. Income is from a "source[] within Indiana" if the taxpayer has an Indiana "commercial domicile" or an Indiana "business situs." First National Leasing 598 N.E.2d 640, 643 (Ind. Tax. Ct. 1992). Since taxpayer maintains that it does not have a commercial domicile within the state, the issue becomes whether it has established an Indiana "business situs."

45 IAC 1.1-1-3(a), (b) provides that, "A 'business situs' arises where possession and control of a property right have been localized in some business or investment activity away from the owner's domicile. A taxpayer may establish a business situs in many ways, including, but not limited to . . . . [o]wnership. leasing, rental, or other business activity connected with income-producing property . . . ." However, taxpayer maintains that it does have an Indiana business situs because all the activities associated with the sales/lease agreements were conducted outside the state. Taxpayer states that although it maintained a secured ownership interest in the leased equipment, it did not exercise any control over the equipment once it was leased to the Indiana customer.

Taxpayer believes its own circumstances are similar to that of the petitioner-taxpayers in Enterprise Leasing v. Indiana Dept. of Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002). In that case, the Tax Court found that an out-of-state company did not receive Indiana source income when it rented Indiana-titled cars to its customers; therefore, the rental income was "not subject to Indiana's gross income tax." Id. at 1292. The court found that that money received from renting Indiana-titled cars was not Indiana source income because it was not the petitioners who decided to register and operate the cars within the state. Id. at 1291. Rather, it was the decision of the individual customers to register and operate the cars in Indiana. Id. The petitioners' activities in sending the cars to its customers "did not rise to the level of 'active participation' in the 'ownership, leasing' or rental' of property in Indiana." Id. The court determined that the "critical transaction" related to the leasing of the cars occurred at the petitioners' out-of-state location. Id. at 1290. Therefore, because the petitioners' activities within the state were "not more than minimal" and were "remote and incidental to the lease transaction from which [petitioners'] income [was] derived," and because the critical transaction occurred outside the state, the petitioners did not have an Indiana "tax situs." Id. at 1292. The court concluded that the petitioners' lease income was not "derived from sources within Indiana" and was not subject to the state's gross income tax. Id.

In further support of its own position, taxpayer cites to Comdisco, Inc. v. Indiana Dept. of Revenue, No. 49T10-9903-TA-19, 2002 Ind. Tax LEXIS 93 (Ind. Tax Dec. 18, 2002), in which the court found that income received from leasing "high technology and medical equipment" to customers within Indiana was not subject to gross income tax. Id. at *5. The court found that the "critical transaction" took place outside Indiana and that "sole activity by the Petitioners in Indiana is ownership of high technology equipment that is located [in Indiana] pursuant to the lessees' direction." Id. at *23. The court concluded that the "[p]etitioners' ownership of equipment located in Indiana is an activity that is not more than minimal, and is remote and incidental to the lease transaction from which [petitioners'] gross income is derived." Id. at *24.

Taxpayer's various Indiana sales/lease transactions are somewhat more complicated than those described in the Enterprise and Comdisco decisions. For example, taxpayer enters into "Conditional Sales Contracts" whereby taxpayer purchases an item of equipment from one of its dealers and simultaneously sells the machine to the Indiana customer by means of a "conditional sales contract." Under this form of agreement, the customer is able to purchase the equipment at the end of the lease term for a nominal amount. The arrangement is less like a lease and more like arrangement in which the taxpayer finances a customer's purchase of the equipment; the customer nominally owns the equipment but the taxpayer maintains a security interest in the equipment during the term of the contract.

Taxpayer also enters into "Installment Sales Agreements" with Indiana customers. In this form of arrangement, one of taxpayer's local dealers sells an item of equipment to an Indiana customer and enters into an installment sales agreement between itself (the dealership) and the customer. Thereafter, taxpayer purchases the installment sales agreement from the dealership. As a result, the relationship between taxpayer and customer is similar to that found under a conditional sales contract; the customer nominally owns the equipment but makes monthly payments until the term of the agreement is complete. After the last payment is made, the customer owns the equipment free-and-clear, and taxpayer's security interest in the equipment is relinquished.

These are representative of the forms of sales/lease agreements by which taxpayer conducts business in this state. What all the agreements have in common is that they enable an Indiana customer to acquire equipment by means of sales/lease transaction. However, taxpayer's sales/lease transactions are not similar to the lease agreements described in either Comdisco or Enterprise. In both those cases, the court found that because the leased equipment had little or no connection with the state of Indiana, the petitioner-lessors did not acquire an Indiana tax situs. Instead, the automobiles and medical equipment was simply cast adrift into a stream of commerce by means of a "critical transaction" which occurred entirely outside the state; that the cars and medical equipment happened to find their way into Indiana, was an occurrence beyond the contemplation or control of the petitioner-lessors. As the court described, "The Petitioners do not exert control over their lessees' use or possession of the leased equipment. The decision as to where the equipment is located and used rests with the lessees alone." Comdisco, 2002 Ind. Tax LEXIS 93, at *23. However, in taxpayer's sales/lease agreements, the Indiana customer (lessee) does not control the location of the equipment. Instead, it is taxpayer which decides whether the equipment will be located in Indiana or whether the lessee may change the location to another state. "Lessee shall not . . . change the use of a Unit from that specified in the Application Survey/Usage Rider attached hereto or *change the location of a Unit from that specified above*, without the prior written consent of the [taxpayer]." The meaning of this proviso in the parties' sales/lease agreement is plain; the leased equipment will not be used in a way not anticipated by the contracting parties and will not be removed from the state unless taxpayer explicitly gives permission.

Taxpayer's sales/lease agreements are essentially sales devices by which taxpayer maintains a security interest in the equipment until the customer completes purchasing the equipment. During the term of the sales/lease agreement, taxpayer exercises a substantial degree of control over the use and location of that equipment. By means of these agreements, taxpayer has created for itself an Indiana "tax situs" such that the income attributable to the agreement is subject to Indiana gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

III. Including the Value of Leased Equipment in Taxpayer's Property Factor – Adjusted Gross Income tax.

Taxpayer suggests that except for "a de minimis amount of repossessed property and property returned at the end of the lease," it has no other property located within Indiana; taxpayer maintains that because the "lessees exercise complete control over the use and location of the

leased equipment," the leased equipment should not be included in the apportionment formula for determining its Indiana adjusted gross income and supplemental net income tax."

Indiana imposes the adjusted gross income tax on each corporation's adjusted gross income derived from sources within this state. IC 6-3-2-2(b). Where a corporation – such as taxpayer – receives income from both Indiana and out-of-state sources, the amount of tax is determined by the apportionment formula set out in IC 6-3-2-2(b). That formula operates by multiplying taxpayer's total business income by a fraction composed of a property factor, a payroll factor, and a sales factor. IC 6-3-2-2(b). The property factor consists of a fraction "the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the taxable year." IC 6-3-2-2(c).

Taxpayer owns equipment located within this state which it leases to Indiana customers. Taxpayer retains title and ownership over the equipment until such time that the lessee decides to buy the equipment or – by the terms of the parties' agreement – the lease term is complete and ownership passes to the lessee. During the term of the agreement, taxpayer retains all the attributes of ownership including the right to unilaterally transfer title to the equipment to a third-party, to prevent the lessee from using the equipment in a manner not originally anticipated by the contracting parties, and to restrict the lessee from moving the equipment to a location not contemplated within the terms of that agreement.

The Department disagrees with taxpayer's contention that – except for the de minimis property cited above – it "has no property located within Indiana" and that the "lessees exercise complete control over the use and location of the leased equipment."

FINDING

Taxpayer's protest is respectfully denied.

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